Effective Date: April 17, 1995

COORDINATED ISSUE
CONSTRUCTION/REAL ESTATE INDUSTRY
CONSTRUCTION MANAGEMENT CONTRACTS

ISSUE

Whether a contract is a construction contract subject to long-term contract accounting under I.R.C. § 460, or a construction management contract that must be accounted for under some other permissible method of accounting under the Internal Revenue Code.

FACTS

The following facts illustrate a typical factual setting in which this issue may arise. A taxpayer (construction manager) executes a contract with an owner to provide construction management services in connection with a large construction project. The contract also provides for the taxpayer to construct fencing for security purposes around the construction site and build roads to allow contractors access to the project. The project begins in August 1989, and is completed in 1992.

More specifically, the construction management services the taxpayer is required to perform involve the management of the construction site and all activities thereon. This includes preparing a construction plan, scheduling contractors work performance, scheduling analysis and control, cost estimating and budgeting, and controlling costs. It also includes supervision and management of construction of all structures into an acceptable configuration. The taxpayer is also responsible for the solicitation of bids and selection of contractors, subject to the owner's approval, that will perform the actual construction work on the project.

The contract further requires the taxpayer to monitor, supervise and coordinate the general contractors so that the actual construction work will be performed in a timely and efficient manner. In its dealings with the general contractors on the project, the taxpayer performs its services as the agent of the owner. Orders, contracts, and any other obligations that the taxpayer incurs with the owner's concurrence are to be in the owner's name, "By Taxpayer, Agent." All orders and contracts placed by the taxpayer are to contain provisions recognizing the taxpayer as the agent of the owner.

Although the taxpayer may stop work for quality reasons, only the owner may expand the scope of the construction services under the contract. The taxpayer may not expand the scope of the services performed under the contract without first advising

the owner of such need, and the probable cost and schedule impact. Moreover, the taxpayer may not expand the scope of the services to be performed without the owner's written authorization.

The owner has the overall responsibility for the construction of the project, and bears the risks of construction defects. The taxpayer assumes complete responsibility for the performance of its services under the contract. However, the taxpayer is not liable for construction defects, except for the fences and roads.

The taxpayer's compensation is based on the reimbursement of the salaries of its employees for the time allocable to the project, plus a percentage of such salaries as an allowance for overhead and administrative costs, and for profit. The taxpayer may also earn performance and milestone incentives if certain goals in the performance of its services are met. Finally, the taxpayer receives a fixed fee in the first year of the contract. The taxpayer reports all revenues from the contract, including the fixed fee, under the percentage of completion method of long-term contract accounting under § 460.

DISCUSSION

The purpose of this issue paper is to highlight the distinctions between the proper accounting methods for certain contracts entered into by construction management (CM) firms and construction contractors. The primary distinction stems from the different activities engaged in by each. Large scale contractors typically engage in actual construction activities. As such, income from contracts not completed before the end of the taxable year during which they are entered into generally must be accounted for under the percentage of completion method of accounting described in I.R.C. § 460 (the "PCM") for federal income tax purposes. Contrarily, since CM firms typically render services rather than perform actual construction, PCM accounting is unavailable. Instead, income and expenses must be accounted for under one of the permissible methods of accounting under § 446. Usually, large CM firms account for income and expenses under the accrual method, but may use any other method sanctioned by § 446 under the appropriate circumstances. The discussion below focuses on the distinctions between these two types of contracts and some of the accounting issues which follow the determination that a contract involves either construction management or actual construction.

1. Construction Management or Construction

As noted, whether a particular contract encompasses construction or construction management activities determines whether income and expenses from such contract must be accounted for under PCM or some other method allowed under § 446. Such

a determination, however, is not based on a bright line test or a broad based rule. In many cases, the determination of whether a contract calls for construction or construction management involves an exceedingly complex analysis. The determination must be based on the unique facts and circumstances of each separate case. No one factor is determinative. All the facts of each individual case, in particular, the rights and obligations of the parties under the contract, must be closely analyzed in light of the applicable law.

Section 460(a) generally requires that the taxable income from any long–term contract be determined under PCM. The term "long–term contract" means any contract for the manufacture, building, installation, or construction of property if the contract is not completed within the taxable year it is entered. I.R.C. § 460(f). A review of the history of long–term contract methods of accounting reveals they were only intended for construction type contracts. The words "construction contract" have reference to particular harmonious, homogeneous activities involving building, installation and construction. Congress reaffirmed this history in 1982, when it defined the term "construction contract", in reference to extended period long–term contracts, as any contract for the building, construction, reconstruction, or rehabilitation of, or the installation of any integral component to real property. See section 229(b)(3) of the Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97–248, 96 Stat. 324, 493 (1982).

Long–term contract accounting methods are justified for construction contracts, in large part, by the difficulty in determining the net profitability of a construction project because of fluctuating and unforeseen costs. See Sam W. Emerson Co. v. Commissioner, 37 T.C. 1063, 1068 (1962); Fort Pitt Bridge Works v. Commissioner, 24 B.T.A. 626, 641 (1931), rev'd on other grounds, 92 F.2d 825 (3d Cir. 1937), cert. denied, 303 U.S. 659 (1938). Rev. Rul. 70–67, 1970–1 C.B. 117 indicates that one of the primary reasons long–term contract accounting methods are provided for long–term construction contracts is because of changes in the price of materials to be used, losses and increased costs due to strikes, penalties for delay, and unexpected difficulties in laying foundations. These "builder's risks" may make it difficult for a contractor in the construction business to estimate with any certainty the amount of gain or loss derived from a particular construction project until the project is completed.

A contract to provide only services that are neither "building, installation, construction, nor manufacturing" is not a long–term contract because such a contract does not call for the taxpayer to "build, install, construct, or manufacture" anything. Rev. Rul. 84–32, 1984–1 C.B. 129 (painting services); Rev. Rul. 82–134, 1982–2 C.B. 88 (engineering and construction management services); Rev. Rul. 80–18, 1980–1 C.B. 103 (engineering services); Rev. Rul. 70–67, 1970–1 C.B. 117 (architectural services). These Revenue Rulings stand for the proposition that contracts which do not require a taxpayer to build, install, or construct anything, even if the services provided are

functionally related to building, installing, or constructing activities, do not qualify for one of the long–term contract accounting methods. See United States v. Howard, 655 F. Supp. 392, 400 (N.D. Ga. 1987), aff'd, 855 F.2d 832 (11th Cir. 1988).

To distinguish between a construction contract and a CM contract, it must be determined whether the activities performed are in the nature of personal services or are those of a general contractor. See Rev. Rul. 82–134. Basically, a general contractor is responsible for building the final product and must correct any mistakes. This responsibility entails control over the construction, not only as to results but also as to the details and means by which the end result is achieved. Id. See also Kurio v. United States, 281 F. Supp. 252, 261 (S.D. Tex. 1968). When the contract requires a taxpayer to perform work and services that are incident and interrelated to the construction performed and the taxpayer is at risk for the construction, then the taxpayer has entered a long–term construction contract. See Rev. Rul. 82–134; Rev. Rul. 80–18.

Such contracts are indicative of the activities performed by a general contractor. As such, a firm acting in the capacity of a general contractor is more likely than not engaged in actual construction rather than construction management. A general contractor contracts with an owner to be responsible for all of the construction work necessary to complete a project, even though subcontractors may be used to perform part or all of the work. Although not determinative, a firm which insures against construction defects and settles payment as construction is performed, may be engaged as a general contractor. The overriding principle is that the contractor is the person who is "building, installing, or constructing" the project.

A CM contract, however, generally involves an agency relationship between the taxpayer and the owner of a construction project where the taxpayer oversees and coordinates the construction activity on the project. This could include any number of services, including negotiating contracts with the general and subcontractors on behalf of the owner for the construction work, coordinating the efforts of all parties involved, or maintaining procedures for cost estimating. In addition, many CM firms also provide engineering and design services such as the preparation of plans, specifications, drawings, bills of material, schedules and estimates. Although these services are not necessarily inconsistent with the activities engaged in by a construction contractor, the CM firm is not responsible for "building, installing, or constructing" anything. The construction is performed by prime or general contractors and their subcontractors. The CM firm provides only services and does neither the actual construction work nor is liable for defects in construction. However, the CM firm may be liable for design defects.

2. Section 460 or Section 446

As noted, a contractor that enters into a long–term contract generally must account for the income from that contract under the PCM. In general, taxpayers must use PCM to account for income earned from long–term contracts entered into on or after July 11, 1989. I.R.C. § 460(a).[1] PCM involves a two–step process. First, the taxpayer annually determines the amount of gross income from the contract. I.R.C. § 460(b)(1)(A). Second, upon completion of the contract, the taxpayer either pays or receives interest computed under the look–back method. I.R.C. § 460(b)(1)(B).

Under PCM, the taxpayer must include in gross income in each taxable year ending after the date that the contract is entered into the excess of (1) the product of (a) the total amount of revenue that the taxpayer estimates it will receive from the contract and (b) the cumulative percentage of the contract that has been completed at the end of the taxable year (the "cost to cost" ratio or the "percentage of completion"), over (2) the total cumulative amount of the contract revenue required to be included in gross income in all preceding percentage of completion method of accounting of section taxable years. I.R.C. § 460(b)(1)(A); Notice 89–15, 1989–1 C.B. 634, 640 Q&A 19. The percentage of completion is equal to the ratio of the total cumulative amount of costs allocable to the contract incurred to date, to the total amount of costs allocable to the contract that the taxpayer expects to incur. I.R.C. § 460(b)(1)(A); Notice 89–15, 1989–1 C.B. at 641 Q&A 20. The costs allocable to the contract are allowable as deductions from gross income in computing taxable income in the year in which such costs are incurred. Notice 89–15, 1989–1 C.B. at 642 Q&A 32.

Income from certain types of long–term construction contracts, however, is not required to be reported under the PCM. See I.R.C. § 460(e). Income from any home construction contract is not required to be reported under PCM. I.R.C. §§ 460(e)(1)(A) and (e)(6)(A). Similarly, the PCM does not apply to any other construction contract entered into by a taxpayer who estimates at the time the contract is entered into that it will be completed within the 2–year period beginning on the contract commencement date, and whose average annual gross receipts for the 3 taxable years preceding the taxable year in which such contract is entered into do not exceed $10,000,000. I.R.C. §§ 460(e)(1)(B) and (2). Special rules are also provided for residential construction contracts which are not home construction contracts. I.R.C. §§ 460(e)(5) and (e)(6)(B). See also Notice 89–15, 1989–1 C.B. at 644 Q&A 41 – 46. As a general matter, these contracts may be accounted for under any other proper accounting method including one of the special long–term contract accounting methods of Treas. Reg. § 1.451–3 (completed contract or percentage of completion accounting). Treas. Reg. § 1.451–3(a)(1). See Notice 89–15,1989–1 C.B. at 634 Q&A 1.

---

[1]For long–term contracts entered into after February 28, 1986, but before July 11, 1989, § 460 also provides for long–term contract accounting under the percentage of completion-capitalized cost method.

Any taxpayer that used a long–term contract method for contracts entered into immediately prior to the effective date of section 460, must use the PCM to account for contracts involving similar activities entered into after the effective date of section 460, even if the taxpayer's position under prior law was based on an erroneous application of the definition of long–term contract. However, the taxpayer may request the permission of the Commissioner to change its method of accounting to a method other than that required under section 460. Notice 89–15, 1989–1 C.B. at 636 Q&A 7.

Section 460 does not apply to CM contracts because they provide for no qualified long–term contract activities, i.e., building, installing, and constructing. These contracts obligate the CM firm to provide construction related services, but contain no qualifying long–term contract activity. The appropriate accounting method for CM contracts is found under section 446. The permissible accounting methods sanctioned by section 446 include the cash receipts and disbursements method, and the accrual method. I.R.C. § 446(c). The method chosen must clearly reflect income. I.R.C. § 446(b). Section 448 provides additional limitations on the use of the cash method. Below, we discuss only those considerations which stem from a CM firm's use of the accrual method. However, it should be noted that under appropriate circumstances, other methods of accounting (not including section 460) could be available to account for CM contracts.

Under ordinary circumstances, accrual tax accounting requires income to be included in gross income when all the events have occurred which fix the right to receive such income and the amount can be determined with reasonable accuracy. Treas. Reg. § 1.451–1(a). Expenses may be deducted under the accrual method when incurred. An expense is incurred in the taxable year in which all events have occurred that establish the fact of the liability, the amount of the liability can be established with reasonable accuracy, and economic performance has occurred with respect to the liability under section 461(h). Treas. Reg. § 1.461–1(a)(2). However, the economic performance rules apply to certain payment liabilities attributable to the CM contract that would, but for the enactment of section 461(h), be allowable as a deduction or otherwise incurred for taxable years beginning after December 31, 1991. See Treas. Reg. § 1.461–4(k)(3).

Thus, CM firms which account for service contracts under PCM or contractors which account for long–term contracts subject to § 460 under an accrual method, are using an incorrect accounting method. Clearly, construction contractors must account for gross income from long–term contracts under § 460. However, the issue is not so clear in the case of a service provider that uses percentage of completion accounting as a form of accrual. Conceptually, the percentage of completion and accrual methods are quite similar. The former method merely provides a different mechanism for determining when income is incurred by tying the recognition of that income to the portion of the job completed. As such, the use of either the accrual method or a

percentage of completion method could yield substantially similar results when applied to the same service contract for the same year. Of course, no look–back calculation would be computed after rendering the services because percentage of completion would be used only as a form of accrual; technically, the contract could not fall within section 460. No adjustment should be proposed in such a case, unless there is a substantial deviation between the results reached under both methods. See I.R.C. § 446(b).

3. Advance Payments for Services

The receipt of an advance payment on a long–term construction contract has no effect on the amount of gross income the contractor includes in income for any particular taxable year under PCM. As mentioned, the gross income for such year is based on the product of the total expected revenue from the entire contract and the percentage of completion determined under an estimated "cost to cost" ratio, less previous years gross income from the contract. Discrepancies in estimates are corrected after the contract is completed under the "look back" provisions of section 460. Accordingly, the receipt of an advance payment for construction work not yet performed is not included in income in the year of receipt by reason of the receipt. Such an amount would be included in the total expected revenue from the contract. See generally Notice 89–15, 1989–1 5 C.B. at 642 Q&A 27 and following. See also Treas. Reg. § 1.451–5(b)(3).

An accrual basis taxpayer generally must include advance payments for services in gross income in the taxable year of receipt. See Schlude v. Commissioner, 372 U.S. 128 (1963); American Automobile Ass'n v. United States, 367 U.S. 687 (1961); Auto. Club of Mich. v. Commissioner, 353 U.S. 180 (1957); Angelus Funeral Home v. Commissioner, 47 T.C. 391 (1967), aff'd, 407 F.2d 210 (9th Cir.), cert. denied, 396 U.S. 824 (1969). Thus, advance payments received for a CM contract should be included in gross income when received. A firm improperly accounting for a CM contract under PCM that receives substantial advance payments for that contract may not be clearly reflecting income. See I.R.C. § 446(b).

Under limited circumstances, however, the inclusion of prepayments for services in gross income may be deferred by an accrual basis taxpayer for one taxable year under Rev. Proc. 71–21, 1971–2 C.B. 549. A taxpayer may request a deferral of an advance payment for services from gross income under Rev. Proc. 71–21 if the contract provides that all services must be performed by the end of the taxable year immediately following the end of the taxable year in which the advance payment is received. In addition, the amount of deferral from gross income for tax purposes must conform to the amount of the deferral from gross income for book purposes. Rev. Proc. 71–21 is not available for any contract where any portion of the services may be performed after the end of the taxable year immediately following the year the advance payment is

received; where any part of the services are to be performed at an unspecified time, possibly after the end of the taxable year immediately following the year the advance payment is received; guaranty or warranty contracts; and contracts for prepaid rent or interest. Other theories may also support the deferral of advance payments for services from gross income, but only in extremely limited circumstances**.** See, e.g., Boise Cascade Corp. v. United States, 530 F.2d 1367 (Ct. Cl.), cert. denied, 429 U.S. 867 (1976); Artnell Co. v. Commissioner, 400 F.2d 981 (7th Cir. 1968); Treas. Reg. § 1.451–1(a). But see Hagen Advertising Displays, Inc. v. Commissioner, 47 T.C. 129 (1966), aff'd, 467 F.2d 1105 (6th Cir. 1969).

4. Mixed Contracts for Services and Construction

In many instances, firms will provide both CM services, including design type services such as architectural and engineering services, in addition to performing actual construction. One example is a taxpayer that enters into a single contract to design and construct a building. Another example is where a firm may contract to provide primarily CM services, and also agree to build ancillary structures which facilitate construction of the primary subject matter of the contract. For instance, a CM firm may enter into a contract to provide architectural and engineering services, and to coordinate bidding among several prime contractors for the construction of a power plant, but not to perform any construction of the plant. Pursuant to the same contract, however, the CM firm agrees to build parking facilities for laborers, install fencing for security purposes during construction of the project, erect and coordinate the use of construction cranes for the various contractors, and build roads to allow the contractors access to the project.

The general rule is that income and expenses attributable to engineering or other similar services that enable the taxpayer to construct the subject matter of a long–term contract must be accounted for as part of a long–term contract under section 460. This is because the services are functionally related to, directly benefit, and are performed by reason of the taxpayer's building, installation, or construction obligation under the same contract. Thus, in the first example above, where the taxpayer contracts to design and build a building, the design services are directly related to the subject matter of the taxpayer's construction activity. The income and expenses attributable to the design services

must be accounted for under section 460 along with the income and expenses attributable to the construction activity.

A contract that provides for the performance of services, however, but does not provide for a qualifying long–term contract activity, may not be bootstrapped into section 460 simply by adding a construction obligation to which the service obligations do not relate. In the second example above, the architectural, engineering, and CM services directly relate to the construction of the plant, not to the ancillary structures which facilitate construction of the plant. Although income and expenses attributable to the construction activities would qualify for section 460 accounting, the services are not sufficiently related to that construction so that the income and expenses attributable to the services could also be accounted for under section 460. In such a case, the income and expenses attributable to the services should be accounted for under the accrual method. The income and expenses attributable to the construction activities, and any services directly related to the construction, should be accounted for under § 460.

CONCLUSION

To distinguish between a construction contract and a CM contract requires a determination as to whether the activities performed are in the nature of personal services or are those of a general contractor. Although no one factor is determinative, analysis of the contract indicates that the taxpayer was acting as an agent for the owner and had no control over the actual construction. The taxpayer was not subject to the risks or liabilities generally associated with the business of "building or constructing", nor was the taxpayer liable for construction defects. Thus, the contract constitutes a CM contract rather than a contract to build or construct, and income and expenses attributable to it may not be accounted for under PCM.

Although the fence and road construction qualifies as a construction activity for purposes of § 460(f)(1), this activity is, nevertheless, unrelated to the subject matter of the contract, which is to manage the construction of the project. Thus, although income and expenses attributable to the construction of the fences and roads must be accounted for under § 460, the service income may not be accounted for under § 460.